

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Cedillo Analyst: John Pavalasky Bill Number: SB 615  
Related Bills: See Legislative History Telephone: 845-4335 Amended Date: February 5, 2004  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Conformity To Federal Servicemembers Civil Relief Act

### SUMMARY

This bill would make California law compatible with the federal Servicemembers Civil Relief Act (SCRA) (PL 108-189) that was enacted on December 19, 2003.

### SUMMARY OF AMENDMENTS

The February 5, 2004, amendments replaced the previous contents of the bill with the provisions discussed in this analysis.

### PURPOSE OF THE BILL

This bill would prevent lengthy and expensive litigation to validate the preeminence of federal law.

### EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. However, consistent with the federal SCRA, this bill specifically provides that it would apply to any taxable year for which the statute of limitations for making assessments or allowing a claim for refund or credit has not expired as of December 19, 2003.

### POSITION

Pending.

#### Summary of Suggested Amendments

Attached are technical amendments necessary to correct cross-references to federal law and add a definition for an undefined term.

### ANALYSIS

#### FEDERAL/STATE LAW

##### Current Federal Law

The SCRA, an Act to restate, clarify, and revise the Soldiers' and Sailors' Civil Relief Act of 1940 (SSCRA), was enacted on December 19, 2003, and includes a number of provisions that affect state and local taxes.

Board Position:

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Department Director

Date

Gerald H. Goldberg

3/9/04

For example, Section 511 of the SCRA, relating to residence for tax purposes, includes a provision that prevents a tax jurisdiction (i.e., California):

from using the military compensation of a non-resident servicemember to increase the tax liability imposed on other income earned by the nonresident servicemember or spouse subject to tax by the jurisdiction.

In other words, this federal language would prevent states from applying to military taxpayers the so-called “California method” of considering all the income (including military compensation) in determining the rate of tax to be applied to the non-military source income of a nonresident and the non-military income of the spouse of that nonresident under current state law.

The SCRA also:

- restates prior law and replaces the term “materially impaired” with the term “materially affected” for consistent usage throughout the act.
- suspends the running of the statute of limitations for the period of a servicemember’s military service.
- limits the rate of interest to 6% per year on any obligation, including a tax underpayment incurred before the servicemember enters military service.
- provides that a servicemember neither loses nor acquires a residence or domicile for purposes of taxation with respect to his or her person, personal property, or income by reason of being absent or present in any tax jurisdiction of the U.S. solely in compliance with military orders.
- specifies that military compensation is not deemed to be income for services performed or from sources within a tax jurisdiction of the U.S. if the servicemember is not a resident or domiciliary of the jurisdiction in which he or she is serving in compliance with military orders.
- codifies case law holding that servicemembers that are Indians possessing a Federal Indian Reservation residence or domicile are not subject to state taxation of their military compensation.

When federal law conflicts with state law, federal law prevails, thereby preempting the incompatible state law.

### Current State Law

With respect to a member of the armed forces stationed in California but domiciled in another community property state, the California Legislature confirmed by statute in 1986<sup>1</sup> that none of the income from military service performed in California is included in gross income even with respect to a resident spouse under the community property law or rules of that state.

In California, the income tax rate that is applied to the non-military income may be based on the servicemember’s total income, including the military pay. This can result in the non-military income being taxed at a higher rate. This method of calculating state income tax is sometimes called the “California Method,” although as many as 18 or more other states also use the method.

The California Constitution provides that a California administrative agency may not refuse to enforce a California statute because of a federal law or federal regulation, unless an appellate court has determined that enforcement of the California statute is prohibited by federal law or federal regulation.<sup>2</sup>

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<sup>1</sup> Revenue and Taxation Code section 17140.5.

<sup>2</sup> Cal. Const., art. III, section 3.5.

The California Attorney General has stated, in another context, that, with respect to federal preemption of conflicting State statutes, article III, section 3.5 of the California constitution must fail because of federal supremacy.<sup>3</sup>

The California Constitution also provides that a California court may not take any action to prevent or enjoin the collection of tax. Only after payment of tax may a court action be maintained to recover tax and interest paid.<sup>4</sup>

### THIS BILL

This bill would make California law compatible with the SCRA. It would provide expressly that:

- the military compensation of a servicemember not domiciled in this state may not be used to increase the tax liability imposed on other income earned by that servicemember or that servicemember's spouse.
- the running of the statute of limitations is suspended for the period of a servicemember's military service.
- the rate of interest is limited to a maximum of 6% per year on any underpayment incurred before the servicemember enters military service.
- a servicemember not domiciled in this state does not become a resident of this state by reason of being present in this state solely in compliance with military orders.
- military compensation of a servicemember not domiciled in this state is not income for services performed or from sources within this state.
- Native American servicemembers whose legal residence or domicile is a federal Indian reservation are treated as living on the federal Indian reservation and the compensation for military service is deemed to be income derived wholly from federal Indian reservation sources.

### TECHNICAL CONSIDERATIONS

During the federal codification process for the SCRA, several section numbers were changed. Attached are technical amendments necessary to correct cross-references to these federal sections as well as a cross-reference to a California section.

In addition, the bill uses the term "Native American" versus the federal use of the term "Indian." A technical amendment is attached to provide Native American has the same meaning as the term Indian for purposes of applying Section 511(e) of the Servicemembers Civil Relief Act (50 U.S.C. App. sec. 571(e)) for federal purposes.

### **LEGISLATIVE HISTORY**

SB 2096 (Ch. 614, Stats. 1986) provided that none of the income from military service performed in California is included in gross income even with respect to a resident spouse under community property law or rules of a state other than California.

AB 850 (Ch. 506, Stats. 1996) enacted the Morrissey Retirement Income Protection Act, which exempts non-resident pension income from tax in conformity with federal law.

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<sup>3</sup> 68 Ops.Cal.Att.Gen. 209, 219-222 (1985).

<sup>4</sup> Cal. Const., art. XIII, sec. 32. Revenue and Taxation Code section 19381 provides for suit in Superior Court to determine residency without payment of tax.

## PROGRAM BACKGROUND

Congress has long recognized that military servicemembers should have civil legal protections so they can “devote their entire energy to the defense of the Nation.” The SSCRA has provided these protections. The SSCRA contains a general relief provision that authorizes a servicemember, at any time during military service or within six months thereafter, to apply to a court for relief of (1) any obligation or liability incurred by the servicemember before active duty, or (2) any tax assessment that falls due before or during active military service. The SSCRA provides additional protections with respect to litigation, eviction, taxes, and insurance. The SSCRA also provides limits on state taxation of servicemembers, their personal property, and their compensation for military service.

Under the SSCRA, servicemembers may only be taxed on their military income by the tax jurisdiction of which they are a resident. Service members may not be taxed on their military pay by the state in which they are stationed if it is not their state of legal residence. However, if a servicemember or spouse earns additional non-military pay, the nonresident state may tax that non-military income.

In certain states with graduated income tax rates, the income tax rate that is applied to the non-military income may be based on the servicemember’s total income, including the military pay. This can result in the non-military income being taxed at a higher rate. This method of calculating state income tax is sometimes called the “California Method,” although as many as 18 or more other states also use the method.

Congress is authorized with war powers in the US Constitution to enact this type of pre-exemptive federal legislation.

## OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

None of these state’s constitutions contain any provision comparable to the California Constitution’s provision that a California administrative agency may not fail to enforce a California statute because of a federal law or federal regulation, unless an appellate court has determined that enforcement of the California statute is prohibited by federal law or federal regulation. (Cal. Const., art. III, section 3.5.)

## FISCAL IMPACT

No departmental costs are associated with this bill.

## ECONOMIC IMPACT

### Revenue Estimate

Fiscal Year	2003-2004	2004-2005	2005-2006
Personal Income Tax [1]	\$0	\$0	\$0
Total	\$0	\$0	\$0

[1] Federal law changes will reduce state personal income tax baseline revenue in the range of \$1 million annually. Making California law compatible with the federal law will have no incremental impact.

### Revenue Discussion

This bill would have no impact on state income revenues since federal law precludes the use of nonresident military income in the calculation of state income tax. However, it is estimated that the federal law change will reduce personal income tax baseline revenue on the order of \$1 million annually. In 2002 there were 126,832 nonresident military personnel stationed in California, of which 66,107 were single and 60,725 were married. The \$1 million baseline revenue loss is based primarily on single military personnel since married couples can file separate tax returns in California under current law and significantly reduce or eliminate any tax liability in California.

### **LEGAL IMPACT**

The SCRA explicitly conflicts with existing provisions of the Revenue and Taxation Code regarding the taxation of nonresidents, thereby implicating provisions of the California Constitution. Article III, sec. 3.5 prohibits an administrative agency from refusing to enforce a California statute on grounds that federal law prohibits the enforcement of that statute unless an appellate court has determined that federal law prohibits enforcement of the California statute. Thus, unless the applicable law is amended, the Franchise Tax Board will be required to continue to enforce the current law unless and until an appellate court rules otherwise.

### **ARGUMENTS/POLICY CONCERNS**

This federal law applies to returns currently being filed for the 2003 and prior tax years as well as to all future tax years. It is urgent that state law be amended to be compatible with the SCRA so that the Franchise Tax Board can implement this change. Otherwise taxpayers will have to wait for a court of appeal decision declaring the California statute unconstitutional, which would be a certain outcome. Waiting for a court decision would require impacted taxpayers to file amended returns or to ignore California law under color of federal law, all of which would result in additional customer service and processing costs for the department. This bill would avoid those additional administrative costs.

In 1996, Section 114 of Title 4 of the United States Code was enacted to limit state income taxation on a source basis with respect to certain pension income. During that same year, California enacted a conforming provision<sup>5</sup> that, for 1996 and later years, specifically provides that gross income of a nonresident from sources within this state does not include "qualified retirement income." This conforming section applies only during the period that the provisions of Section 114 of Title 4 of the United States Code, relating to limitation on state income taxation of certain pension income, are effective.

### **LEGISLATIVE STAFF CONTACT**

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<sup>5</sup> Revenue and Taxation Code section 17952.5.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 615  
As Amended February 5, 2004

AMENDMENT 1

On page 2, line 14, after "Sec." strikeout "525" and insert:

526

AMENDMENT 2

On page 2, line 23, after "Sec." strikeout "526" and insert:

527

AMENDMENT 3

On page 2, line 29, after "Sec." strikeout "574" and insert:

571

AMENDMENT 4

On page 3, line 25, after "Section" strikeout "17054.5" and insert:

17024.5

AMENDMENT 5

On page 3, line 32, after "(e)" insert:

(1)

AMENDMENT 6

On page 3, after line 36, insert:

(2) "Native American" has the same meaning as the term "Indian" for purposes of applying Section 511(e) of the Servicemembers Civil Relief Act (50 U.S.C. App. sec. 571(e)) for federal purposes.